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Federal Communications Commission
Office of Secretary

EX PARTE

April 7, 1997

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, NW Room 222
Washington, DC 20554

Re: Ex Parte Presentation in CC Docket No. 96-262

Dear Mr. Caton:

On Friday, April 4, 1997, Brad Stillman (MCI), Michael Pelcovits (MCI), Tony Epstein, from Jenner & Block representing MCI, Paul Smith, from Jenner & Block representing MCI, and I met with Jim Casserly, Senior Legal Advisor to Commissioner Ness, Dan Gonzalez, Legal Advisor to Commissioner Chong, Gail McGuire from the Office of Commissioner Chong, and Jim Coltharp, Special Counsel to Commissioner Quello. The purpose of the meeting was to discuss MCI's position as filed in MCI's comments in the above captioned proceeding. The discussion focused on issues related to the Fifth Amendment and depreciation. The attached documents were used during the meeting and briefly outline the issues discussed.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206 (a)(2) of the Commission's rules the next business day.

Sincerely,

Kimberly M. Kirby

Kimberly M. Kirby

Attachments

cc: Jim Cassserly (letter only)
Jim Coltharp (letter only)
Dan Gonzalez (letter only)
Gail McGuire (letter only)

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BASING INTERSTATE ACCESS CHARGES ON THE FORWARD-LOOKING COST OF PROVIDING THAT SERVICE WOULD NOT CONSTITUTE A "TAKING"

It is spurious to suggest that it would constitute a "taking" under the Fifth Amendment[1/] to require ILECs to sell access to IXCs at rates based on forward-looking economic cost. The Commission itself so recognized in requiring ILECs to provide essentially the same service to local competitors at prices based on the forward-looking cost of each element of service ("TELRIC").[2/] Under settled Takings jurisprudence, that conclusion was both correct and fully applicable to the issue of interstate access charges.

The Constitution Does Not Require Access Charges Based on Historical Costs.

Agencies are "not bound to the use of any single formula or combination of formulae in determining rates." Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944). A past practice of rate-setting based on historical costs does not bar a change to a new system. See, e.g., Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989); Wisconsin v. Federal Power Commission, 373 U.S. 294 (1963). Nor do utilities have a right to the maintenance of a particular overall level of return. The mere "fact that the value [of the utility's property] is reduced does not mean that the [rate] regulation is invalid." Hope, 320 U.S. at 601.

The Only Constitutional Question is Whether the Overall Rate Structure Jeopardizes the Regulated Utility's Financial Integrity.

Because, as the Hope Court noted, "the rate-making process . . . i.e., the fixing of 'just and reasonable'

1/ U.S. Const. amend. V ("nor shall private property be taken for public use, without just compensation").

2/ First Report and Order, Implemention of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, ¶ 736 (August 8, 1996).

rates, involves a balancing of the investor and the consumer interests," id. at 603, regulators have a broad "zone of reasonableness" in setting rates. E.g., In re Permian Basin Area Rate Cases, 390 U.S. 747, 770 (1968). The Constitution only bars overall rates that are so low as to "jeopardize the financial integrity of the [regulated] companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital." Duquesne, 488 U.S. at 312 (emphasis added); see also Federal Power Commission v. Texaco, Inc., 417 U.S. 380, 391-92 (1974) ("All that is protected against, in a constitutional sense, is that the rates fixed by the Commission be higher than a confiscatory level."); Permian Basin, 390 U.S. at 769 ("Regulation may, consistently with the Constitution, limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness.").

Rates Based on the Current Economic Cost of Providing a Service, including a Reasonable Return, Cannot, in Principle, Violate the Constitution.

Requiring access charges based on economic cost, including a reasonable return, cannot be unconstitutional. Such rates would allow ILECs to earn a reasonable return on the current market value of the assets being used to provide access. That is all that they could expect to earn in a competitive marketplace. In a period of transition to competition, the Constitution cannot be violated by a rate methodology that "mimics the operation of the competitive market" and "gives utilities strong incentive to manage their affairs well and to provide efficient services to the public." Duquesne, 488 U.S. at 308-09.

Rates Do Not Become Unconstitutional Because They Require a Company to Write Off Some of its Prior Investments, Even if those Investments Were "Prudent" When Made.

> Access charges based on the current costs of providing access services would not provide ILECs with a guaranteed return on past investments in assets that now constitute excess capacity or use expensive, outmoded technology. But that is not required. Duquesne, 488 U.S. at 315-16; Market Street Ry. v. Railroad Comm'n, 324 U.S. 548, 562 (1945). If that were the constitutional requirement, it would be unconstitutional to subject a formerly regulated monopoly to competition. Thus, in Illinois Bell Tel. Co. v. FCC, 988 F.2d 1254 (D.C. Cir. 1993), the court rejected a Takings challenge to a rate order that served to "exclude part of [an] original investment from the rate base." Id. at 1263. Noting that the Commission has no obligation "to include in the rate base all actual costs for investments prudent when made," the court squarely held that, even if the exclusion resulted in a loss of revenues, "there simply has been no demonstration that the FCC's rate base policy threatens the financial integrity of [ILECs] or otherwise impedes their ability to attract capital." Id. Nor could such a showing be made here.

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A CHANGE TO ACCESS CHARGES BASED ON FORWARD-LOOKING COSTS IS FULLY AUTHORIZED UNDER THE ACT AND WOULD BE AN ENTIRELY REASONABLE EXERCISE OF THE COMMISSION'S DISCRETION

The Communications Act Does Not Mandate Traditional Rate-of-Return Methods of Rate-Setting.

As the price-cap regulations illustrate, the Commission has ample authority under section 201 of the Act to depart from rate-setting methodologies that provide a rate of return based on historical costs. In fact, the "just and reasonable" standard in section 201 is no more demanding than the constitutional "just and reasonable" test, which plainly permits rate-setting based on present market value and/or forward-looking costs.

An Historical Practice of Using One Rate-Setting Methodology Does Not Preclude Adoption of a New One, Where There is a Rational Explanation for Such a Change.

The fact that the Commission had an existing practice of basing access charges on historical costs does not mean that it would be "arbitrary, capricious or an abuse of discretion" to change course. A regulatory agency, "faced with new developments or in light of reconsideration of the relevant facts and its mandate, may alter its past interpretation and overturn past administrate rulings and practice." American Trucking Ass'ns v. Atchison, Topeka, and Santa Fe Ry. Co., 387 U.S. 367, 416 (1967). As long as it supplies a reasoned explanation, "an agency must be given ample latitude to 'adapt [its] rules and policies to the demands of changing circumstances.'" Motor Vehicle Manuf. Ass'n v. State Farm Mut. Automobile Ins. Co., 463 U.S. 29, 42 (1983) (quoting Permian Basin Area Rate Cases, 390 U.S. 747, 784 (1968)).

The ILECs Cannot Claim that They Received Some Sort of Unspoken Promise that Rate-of-Return Rate-Setting Would Continue Forever.

There is no basis for the suggestion that regulators made some sort of "compact" with the ILECs, guaranteeing permanent rate-setting based on historical costs. The law has for many decades authorized regulators to change to other methods. Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944). And by imposing price caps, the Commission has already largely abandoned historical cost as the basis of regulation.

Changed Circumstances Fully Justify a Change to Access Charges Based on Forward-Looking Costs.

The 1996 Telecommunications Act virtually compels a move in the direction of access charges based on forward-looking costs. The Act has opened up local markets, including the market in exchange access, to competition. When that policy succeeds, ILECs will have no choice but to price access based on forward-looking costs. But the move toward competition cannot succeed as long as the ILECs are receiving a huge subsidy in the form of inflated access charges because the ILECs will be able to build an anti-competitive war chest. These unwarranted subsidies can be used by ILECs to solidify their hold on their local monopoly markets.

Moreover, the 1996 Act has also opened up long distance to competition from the RBOCs. In order to prevent unfair competition in this market, it is essential that the RBOCs not be allowed to charge higher access charges to competitors than they will incur in providing access to themselves or an anti-competitive price squeeze is inevitable. This is especially the case if terminating access, which is not subject to competitive market pressures, remains above cost. Furthermore, the provision of an integrated local and long distance product will make identification of cross-subsidy and predatory activities far more difficult to discover. Finally, the 1996 Act requires the elimination of implicit subsidies. Thus, the goal of "universal service" can no longer be used to justify bloated access charges.

RBOC RESERVE DEFICIT BASED ON FCC PRESCRIBED LIVES

- RESERVE DEFICIT FOR RBOCS IN 1994 IS ONLY $3 BILLION ON A TOTAL INVESTMENT OF $200 BILLION

- RESERVE DEFICIT HAS DECLINED DRAMATICALLY IN THE LAST TEN YEARS, AS TOTAL RESERVES HAVE CLIMBED

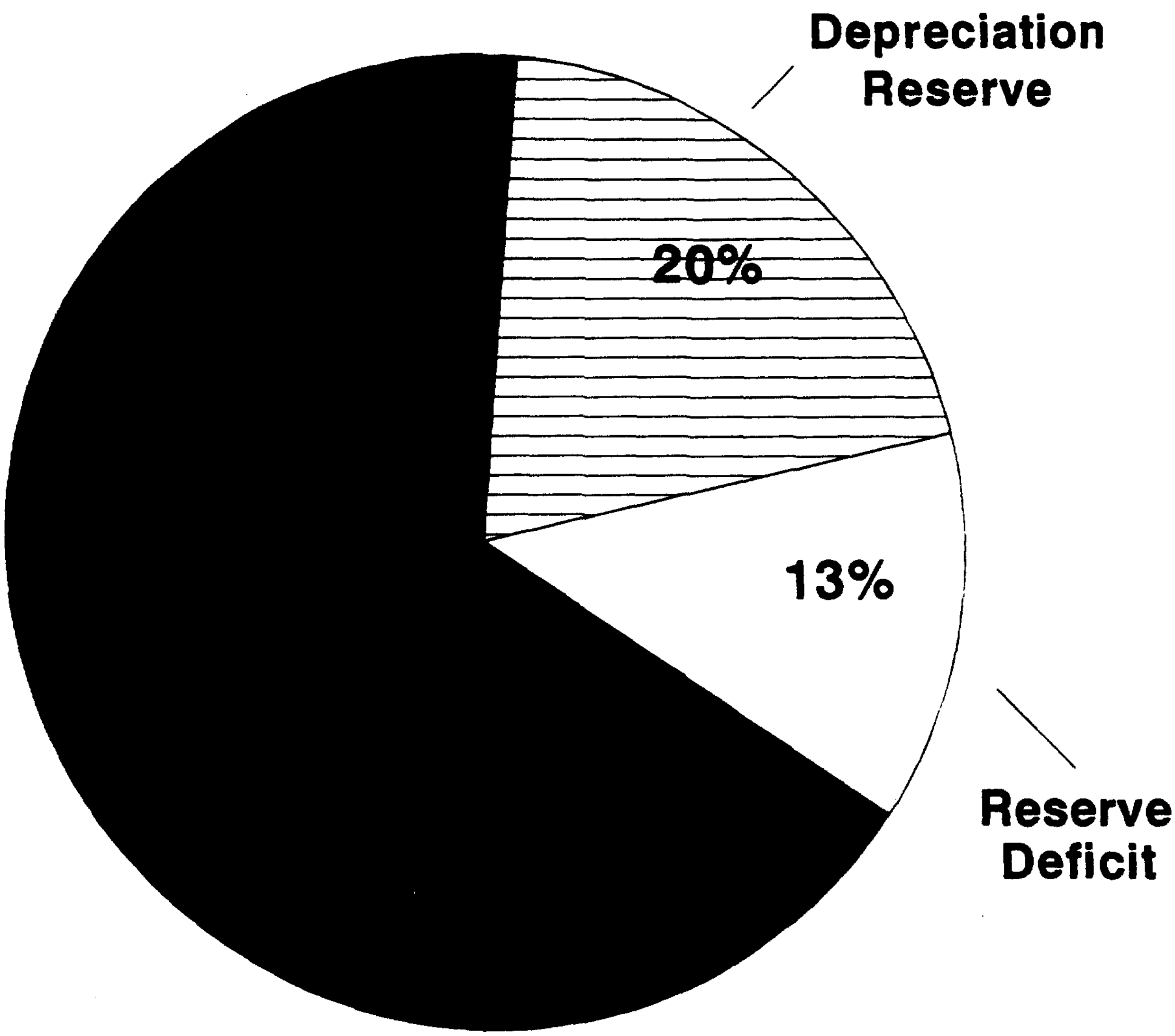
- RESERVE DEFICIT IS EQUAL TO 1.6% OF GROSS BOOK VALUE AND 2.7% OF NET BOOK VALUE

- IF AMORTIZED OVER FIVE YEARS, THE RESERVE DEFICIT WOULD EQUAL 1% OF RBOC TOTAL REVENUES

Figure 1

Depreciation Reserve & Reserve Deficit As a Fraction of Gross Book Value: All LECs

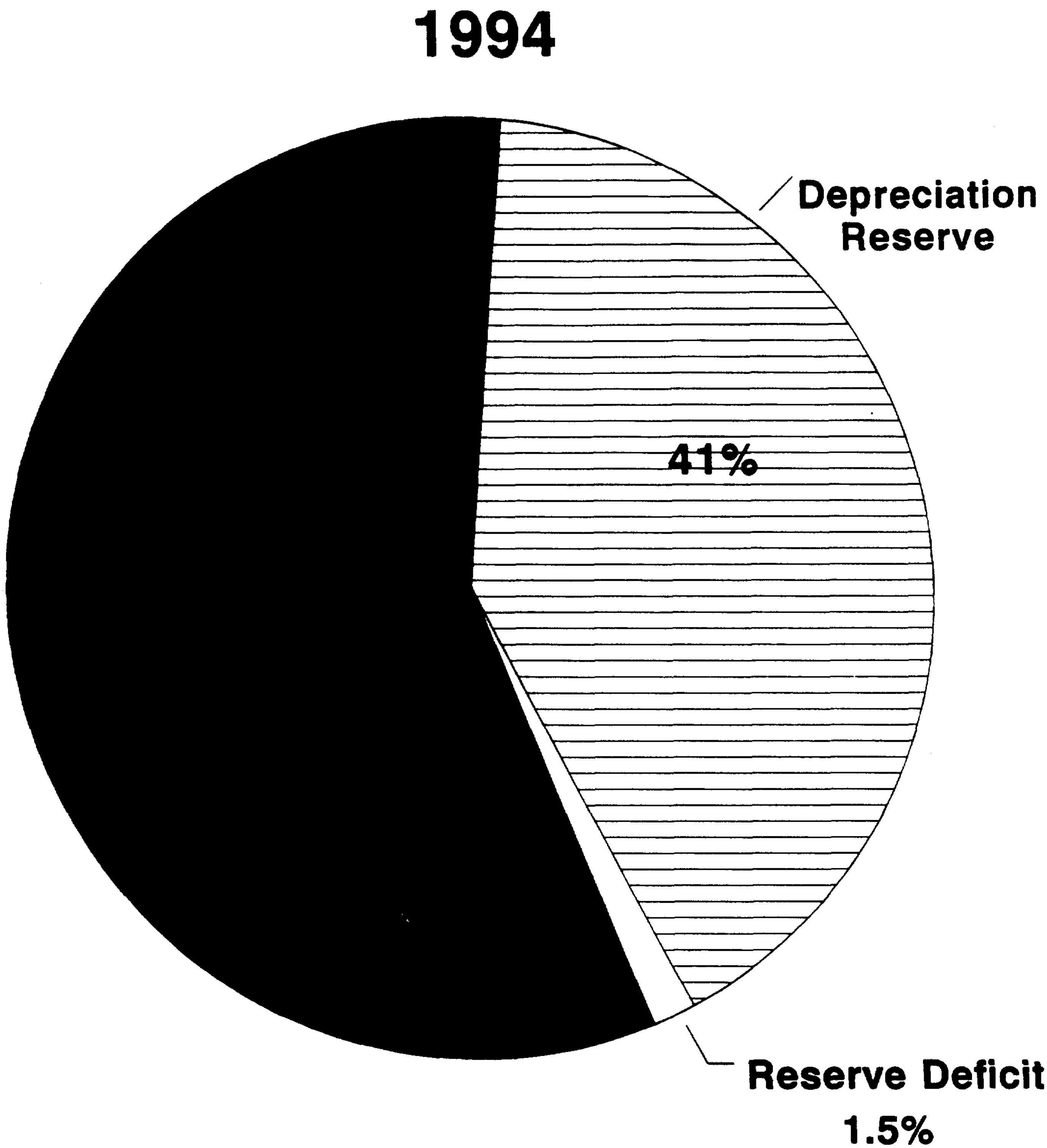
1983



Gross Book Value of Plant = $160 billion

Figure 2

Depreciation Reserve & Reserve Deficit As a Fraction of Gross Book Value: All LECs



Gross Book Value of Plant = $228 billion

RBOC RESERVE DEFICIT BASED ON RBOC PROPOSED LIVES

- 1994 RESERVE DEFICIT BASED ON RBOC-PROPOSED SERVICE LIVES WAS $2 BILLION HIGHER THAN FCC-BASED ESTIMATE

- RBOC PROPOSED REPRESCRIPTIONS IN 1995 SHOW MUCH GREATER DIVERGENCE FROM FCC

- DIFFERENCE IN TREATMENT OF SUBSCRIBER CABLE ACCOUNTS FOR 75% OF DIFFERENCE BETWEEN RBOC PROPOSED AND FCC ORDERED REPRESCRIPTION

- SHORTER ASSETS LIVES FOR COPPER IN THE LOOP SHOULD NOT INCREASE RATES FOR BASIC TELEPHONE SERVICES

Figure 3

Depreciation Reserve & Reserve Deficit As a Fraction of Gross Book Value: RBOCs

1994

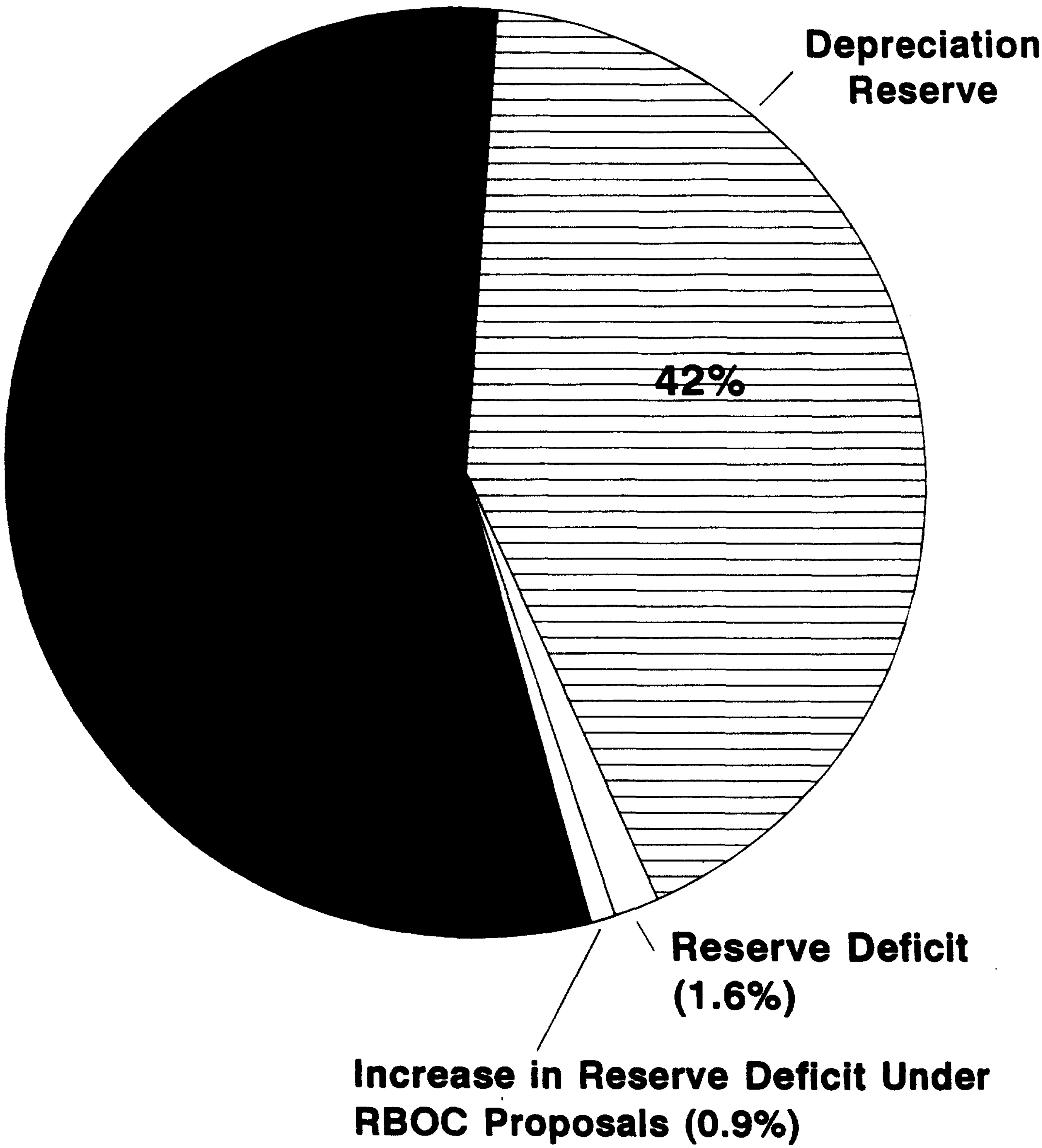


Figure 6
Comparison of Reserve Deficit for Metallic Cable vs. All Categories
1994